Franchise Tax Board **ANALYSIS OF AMENDED BILL**

Author:	Committee On Budget	Analyst:	Gail Hall	Bill Number:	SB 858
Related Bills:	See Legislative History	Telephone:	845-6111	Amended Date:	October 7, 2010
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT:	Use Tax On Tax Returns/Federal Disaster Loss Net Operating Loss (NOL) Carrybacks Inapplicable/Suspend NOLs 2010 & 2011/Delay NOL Carrybacks/Modify Large Corporate Understatement Penalty(LCUP)/Clarify Bright-line Test/Reinstate Pre-2011 Rules For Assigning Intangibles & Services To Nonelectors of Single Sales Factor Formula & If Single Sales Factor Provision Is Inoperative

SUMMARY

Provisions of this bill would make the following changes:

Provision No. 1: Allow for the reporting of use tax on income tax returns.

Provision No. 2: Make the federal disaster NOL carryback rules inapplicable for state purposes, delay the operative date for NOL carrybacks, and suspend NOL deductions for two years.

Provision No. 3: Modify the LCUP.

Provision No. 4: Clarify one aspect of the bright-line test for determining when an entity is doing business in California for purposes of the franchise tax.

Provision No. 5: Reinstate pre-2011 rules for assigning sales of intangibles and services for nonelectors of the single sales factor formula and for all businesses if the single sales factor provisions are inoperative.

This analysis will not address the bill's Collection Cost Recovery Fee provisions as they do not impact the department or state income tax revenue.

SUMMARY OF AMENDMENTS

The October 7, 2010, amendments removed the intent language to enact statutory changes to the Budget Act of 2010, and added or amended the provisions summarized above.

This is the department's first analysis of this bill.

EFFECTIVE/OPERATIVE DATE

As an urgency measure, this bill would go into immediate effect. The operative dates of these changes vary and will be addressed separately for each provision.

Board Position:			Department Director	Date
____ S	____ NA	____ NP		
____ SA	____ O	____ NAR	Selvi Stanislaus	10/14/10
____ N	____ OUA	X PENDING		

POSITION

Pending.

ECONOMIC IMPACT - SUMMARY REVENUE TABLE

	2009-10	2010-11	2011-12	2012-13
Two Year Suspension Of NOLs/Delay NOL Carrybacks	-	+$1,200	+$410	-$205
Exception To Current Law, NOL Suspension For Taxpayers In Certain Reorganizations	(1)	-	-	-
20% Threshold For Application Of 20% LCUP		-$105	-$105	-$95
Interaction Between NOL Suspension And LCUP		-$12	-$4	$2
If the SSF election Is Operative, Non-electors Must Use Cost Of Performance Instead Of Market Rule		-$28	-$95	-$100
Interaction Between NOL Suspension And Cost Of Performance		-$3	-$9	-$4
Totals:		+$1,052	+$197	-$402
Total Net Revenue Impact (rounded):		+$1,100	+$200	-$400

(1) We are unable to provide an estimate for this provision because doing so would violate Franchise Tax Board (FTB) taxpayer confidentiality laws. However, for every $100 million in NOLS that taxpayers would be able to use to offset income, there would be a revenue loss of approximately $8.8 million.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this measure.

PROVISION NO. 1: USE TAX REPORTING ON INCOME TAX RETURN

EFFECTIVE/OPERATIVE DATE

As an urgency measure, this provision would be effective immediately upon enactment and would be specifically operative for purchases of tangible personal property made on or after January 1, 2010, in taxable years beginning on and after January 1, 2010.

ANALYSIS

STATE LAW

California use tax is imposed on any person who purchases tangible personal property for use, consumption, or storage in this state where the purchase is not subject to California sales tax. Generally, use tax is applied in instances where the sale is not made in California, but the property is purchased for use in California, such as purchases shipped from out-of-state retailers to a California consumer. The state use tax rate is the same as the sales tax rate. The State Board of Equalization (BOE) is responsible for collecting sales and use tax. Beginning with income tax returns filed for taxable years on and after January 1, 2003, and ending on or before December 31, 2009, taxpayers may elect to report and pay state use tax on their state income or franchise tax return or file a use tax return directly with the BOE.

THIS PROVISION

This provision would reenact the provisions of prior law for purchases of tangible personal property made on or after January 1, 2010, in taxable years beginning on or after January 1, 2010, with no termination date, thereby allowing taxpayers to continue the election to file and pay use tax on their income tax return permanently.

FISCAL IMPACT

Changes in the instruction booklets required by this provision could be accomplished during normal annual revisions and would have a minor impact on the department's costs.

ECONOMIC IMPACT

This provision would not impact the state's income tax revenue.

PROVISION NO. 2: DISASTER LOSS NOLS/DELAY NOL CARRYBACKS/SUSPEND NOLS

(Sections 17276, 17276.05, 17276.20, 17276.21, 17276.22, 24416, 24416.05, 24416.20, 24416.21, and 24416.22)

EFFECTIVE/OPERATIVE DATE

As an urgency statute, these provisions would be effective immediately upon enactment and would be specifically operative as follows:

1. Federal law sections relating to the carryback of NOLs attributable to disaster losses: specifically operative for taxable years beginning on or after January 1, 2011.
2. Delay NOL Carryback Provisions: NOL carrybacks would be delayed two years and losses attributable to taxable years beginning on or after January 1, 2013, could begin to be carried back.
3. Suspension of NOL deductions: operative for taxable years beginning on or after January 1, 2010, and before January 1, 2012.

ANALYSIS

Federal/State Law – Disaster Loss NOLs

A casualty loss occurs when business or personal property is completely or partially destroyed as a result of a fire, storm, flood, or other natural event. The deduction of a casualty loss can create an NOL.

In general, a federal NOL may be carried back 2 years and carried forward 20 years to offset taxable income in other tax years. Different rules apply with respect to NOLs arising in certain circumstances such as disaster losses incurred in an area declared to be a disaster by the President of the United States.

Internal Revenue Code (IRC) section 172(b)(1)(J) provides a special 5-year carryback period for NOLs attributable to "qualified disaster losses." IRC section 172(j) defines a "qualified disaster loss" as the lesser of:

1. the sum of:
    - A. losses for a taxable year attributable to a federally declared disaster occurring in a disaster area occurring before January 1, 2010, and
    - B. the allowable deduction for the taxable year for qualified disaster expenses.
2. the NOL for the taxable year.

California generally follows federal law regarding the treatment of casualty losses incurred as a result of a disaster, unless California enacts legislation for special disaster loss treatment.[1] If California enacts legislation for special disaster loss treatment, the disaster losses are not eligible for California NOL treatment, as they would be under federal law; however, like the treatment provided to Presidentially-declared disaster losses under federal and state law, a taxpayer may elect to deduct a California-only disaster loss either on an amended tax return for the tax year preceding the year of the disaster or on the tax return filed for the year of the disaster and 100 percent of the excess disaster loss may be carried forward for 15 years. Although, under current state law, no NOL carrybacks are allowed for losses attributable to taxable years beginning before January 1, 2011.

Federal Law – NOLs

When a taxpayer has a net operating loss for a taxable year, the operating loss that may be deducted in subsequent years is called an NOL. An operating loss occurs when a taxpayer's allowed deductions exceed their gross income for that year. Federal law provides, in general, that an NOL can be carried back 2 years and forward 20 years and deducted. Special rules are provided for the carryback of NOLs relating to issues such as specified liability losses, casualty or theft losses of individuals, disaster losses of a small business, and farming losses. For NOLs arising in taxable years ending after December 31, 2007, an eligible small business can elect to increase the NOL carryback period for an applicable 2008 or 2009 NOL from 2 years to 3, 4, or 5 years.

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[1] Revenue and Taxation Code (R&TC) Section 17207.

State Law – NOLs

In general, a California taxpayer calculates its NOL in accordance with federal rules. For NOLs attributable to taxable years beginning before January 1, 2008, California limits the carryforward period to 10 years in circumstances where federal law allows 20 years. For NOLs attributable to taxable years beginning before January 1, 2011, NOL carrybacks are disallowed.

NOLs attributable to taxable years beginning on or after January 1, 2008, may be carried forward 20 years. California conforms to the federal NOL carryback rules for NOLs attributable to taxable years beginning on or after January 1, 2011, with the following modifications:

1. An NOL may be carried back only 2 years. (Federal law has special rules that in some cases allow an NOL to be carried back for a longer period).
2. The amount of NOL carryback attributable to taxable year 2011 is limited to 50 percent of the NOL.
3. The amount of NOL carryback attributable to taxable year 2012 is limited to 75 percent of the NOL.

Current state law conforms to the federal carryback period for a Real Estate Investment Trust and a corporate equity reduction interest loss, which is zero.

NOL deductions are suspended for taxable years 2008 and 2009 for a taxpayer with net business income (PITL[2]) and income subject to tax (CTL[3]) of $500,000 or more. However, deductions for NOL carrybacks from taxable years beginning on or after January 1, 2011, would be allowed.

- For PIT, "net business income" means income from a trade or business, whether conducted by the taxpayer or by a pass-through entity (partnership or S corporation), income from rental activity, and income attributable to a farming business.

THIS PROVISION

This provision would apply to both PITL and CTL and would make the following changes:

- Provide that IRC section 172(b)(1)(J), relating to the special 5-year carryback period for NOLs attributable to "qualified disaster losses," and IRC section 172(j), relating to definitions and rules for the 5-year carryback period, would not apply for California purposes.
- Delay the operative date for NOL carrybacks to losses incurred in taxable years beginning on or after January 1, 2013 (versus 2011).

[2] Personal Income Tax Law.
[3] Corporation Tax Law.

- Disallow NOL deductions by suspending them for taxable years 2010 and 2011 for a taxpayer with modified adjusted gross income (PITL) or preapportioned income (CTL) of $300,000 or more. However, deductions for NOL carrybacks from taxable years beginning on or after January 1, 2013, would be allowed.
  - "Modified adjusted gross income" would mean the amount required to be shown as adjusted gross income on the federal tax return for the same taxable year[4] without taking into consideration the NOL deduction[5].
  - "Preapportioned income" would mean net income after state adjustments before the application of the apportionment and allocation provisions under CTL.
- The amount of NOL carryback attributable to taxable year 2013 would be limited to 50 percent of the NOL and the amount of NOL carryback attributable to taxable year 2014 would be limited to 75 percent of the NOL.
- Extend the NOL carryover period by one year for NOLs incurred in taxable year 2010, two years for NOLs incurred in taxable year 2009, three years for NOLs incurred in taxable year 2008, and four years for NOLs incurred in taxable years beginning before January 1, 2008.
- Provide a retroactive exemption under CTL from the 2008 NOL suspension rules for a taxpayer that ceased to do business or had a final taxable year ending prior to August 28, 2008, that sold or transferred substantially all of its assets resulting in a gain on sale during a taxable year ending prior to August 28, 2008, and the sale or transfer occurred pursuant to a plan of reorganization under Chapter 11 of Title 11 of the United States Code.

TECHNICAL CONSIDERATION

- The provision added by this bill that would make the federal 5-year disaster loss carryback period (IRC 172(b)(1)(J)[6]) inapplicable for state purposes is unnecessary because California law currently modifies IRC section 172(b)(1) and provides that NOL carrybacks are for two taxable years in lieu of the federal carryback periods.
- The provision added by this bill that relates to federal disaster loss carrybacks, references R&TC sections 17276 and 24416 that would be repealed under this bill, creating a cross-referencing error that would need to be corrected in a future technical clean-up bill.
- Long standing California NOL provisions, sections 17276 and 24416, would be repealed under this bill. A technical cleanup bill would be necessary to correct all of the cross-referencing errors throughout the California R&TC that refer to these sections.

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[4] R&TC section 17024.5(h)(2).
[5] IRC section 172.
[6] See the Federal/State Law discussion in the department's analysis of the bill as amended July 15, 2010, for an explanation of IRC 172(j) and IRC 172(b)(1)(J).

LEGAL CONCERN

It is unclear what impact, if any, Proposition 24, which qualified for the November 2, 2010, ballot, would have on this bill should both be enacted. Among other things, Proposition 24 would amend existing law to restore a 10-year carry forward period for NOLs and prohibit any carryback of NOLs.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

	2009-10	2010-11	2011-12	2012-13
Two Year Suspension Of NOLs/Delay NOL Carrybacks	-	+$1,200	+$410	-$205
Exception To Current Law, NOL Suspension For Taxpayers In Certain Reorganizations	(1)	-	-	-

(1) We are unable to estimate this provision because doing so would violate FTB taxpayer confidentiality laws. However, for every $100 million in NOLS that the taxpayers would be able to use to offset income, there would be a revenue loss of approximately $8.8 million.

PROVISION NO. 3: LCUP (Section 19138)

EFFECTIVE/OPERATIVE DATE

As an urgency measure, this provision would be effective upon enactment, and would be specifically operative for taxable years beginning on or after January 1, 2010.

FEDERAL/STATE LAW

Federal Law

There is no comparable penalty under federal law.

State Law

The LCUP is assessed against any corporation that has an "understatement of tax" in excess of $1 million in any open taxable year beginning on or after January 1, 2003. In the case of taxpayers that are required or authorized to be included in a combined report, the $1 million threshold applies to the aggregate amount of tax liability for all taxpayers that are required or authorized to be included in the combined report.

The penalty is 20 percent of the “understatement of tax.” For purposes of this penalty, “understatement of tax” means the difference between the amount of tax shown on an original return (or amended return, if filed on or before the extended due date of the original return) and the correct amount of tax. For any taxable year beginning before January 1, 2008, amounts paid on or before May 31, 2009, and reported on an amended return filed on or before May 31, 2009, are treated as the amount of tax shown on an original return.

A corporation may not protest or appeal the imposition of the LCUP, and the LCUP is imposed in addition to any other applicable penalty.

The penalty does not apply to any understatement of tax that is attributable to:

- A change in law, a regulation, a legal ruling of counsel, or a published federal or California court decision that occurs after the earlier of either the date the taxpayer files the return for the taxable year for which the change is operative or the extended due date for the return of the taxpayer for the taxable year for which the change is operative; or

- A taxpayer’s reasonable reliance on written advice of the FTB, but only such advice was a legal ruling by the Chief Counsel (within the meaning of the Taxpayers' Bill of Rights).

A credit or refund for any amounts paid to satisfy the penalty may be allowed only on the grounds that the amount of the penalty was not properly computed by the FTB.

THIS PROVISION

This provision would amend the LCUP to provide that it would apply to an “understatement of tax” only if such understatement exceeds the greater of:

- $1 million; or
- 20 percent of the tax shown on an original return (or amended return filed on or before the original or extended due date of the original return).

As under current law, in the case of taxpayers required to be included, or eligible to be included, on a combined report, the tax liability of the members of that combined group would be aggregated for purposes of determining the amount of any understatement.

FISCAL IMPACT

This provision would not significantly impact the department’s costs.

ECONOMIC IMPACT

	2009-10	2010-11	2011-12	2012-13
20% Threshold for Application of 20% LCUP		-$105	-$105	-$95

PROVISION 4: CLARIFY BRIGHT-LINE TEST FOR WHEN AN ENTITY IS DOING BUSINESS IN CALIFORNIA (Section 23101)

EFFECTIVE/OPERATIVE DATE

As an urgency measure, this provision would be effective upon enactment, and operative for taxable years beginning on or after January 1, 2011.

ANALYSIS

FEDERAL LAW

A corporation is subject to federal income tax if it is formed in the United States or it conducts a trade or business in the United States.

STATE LAW

For a state (or other taxing jurisdiction) to impose a tax, the Due Process and Commerce Clauses of the U.S. Constitution require that the taxpayer have a certain minimum connection, or nexus, within the state. California utilizes the term "doing business" to establish liability for the corporate franchise tax. "Doing business" is defined in current state law as actively engaging in any transaction for the purpose of financial or pecuniary gain or profit.[7]

For taxable years beginning on or after January 1, 2011, a bright-line test was established that provides that a taxpayer is doing business in California if any of the following conditions are satisfied:

1. The taxpayer is organized or commercially domiciled in this state.
2. Sales of the taxpayer in this state exceed the lesser of $500,000 or 25 percent of the taxpayer's total sales. Sales of the taxpayer would include sales by an agent or independent contractor of the taxpayer.
3. The real and tangible personal property of the taxpayer in this state exceeds the lesser of $50,000 or 25 percent of the taxpayer's total real and tangible personal property.
4. The amount paid in this state by the taxpayer for compensation exceeds the lesser of $50,000 or 25 percent of the total compensation paid by the taxpayer.

[7] R&TC section 23101(a).

The FTB is required to revise the amounts described in items 2, 3, and 4 above on an annual basis to take into account changes in the California consumer price index in a similar manner used to recompute the state income tax brackets.

THIS PROVISION

This provision would clarify that the market rule[8] for assigning sales of other than tangible property (see Provision No. 5) is retained for determining the bright-line test relating to sales.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

This provision would not impact the state's income tax revenue.

PROVISION 5: REQUIRE SINGLE SALES FACTOR NONELECTORS TO UTILIZE PRE-2011 RULES FOR ASSIGNING INTANGIBLES AND SERVICES & ALL TAXPAYERS TO UTILIZE PRE-2011 RULES IF THE SINGLE SALES FACTOR PROVISON IS INOPERATIVE (Section 25136)

EFFECTIVE/OPERATIVE DATE

As an urgency measure, the amendments to this provision would be effective upon enactment, and would be operative for taxable years beginning on or after January 1, 2011.

ANALYSIS

Federal Law

The issues discussed in this provision are not applicable to federal law because the federal method of taxation is different from the California method.

State Law

Current state law provides the following general rules to determine California sales for the sales factor calculation:

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[8] R&TC section 25136(b).

Pre-2011 Rules For Assigning Sales

Sales of Tangible Personal Property

- Sales of tangible personal property are assigned to California if the product is delivered or shipped to a purchaser in this state, and the taxpayer (seller) is taxable in this state.
- Sales of tangible personal property are assigned to California if the product is delivered or shipped from California to a purchaser out of state, and the taxpayer (seller) is not taxable in the state of destination.
- Sales of tangible personal property to the U.S. Government are assigned to California if the goods are shipped from California.

Sales of Other Than Tangible Personal Property

- Sales from the performance of personal services are assigned to California if the services are performed in California. If personal services are performed in more than one state, then the receipts from the services are assigned to California based on the ratio of time spent performing such services in the state to total time spent in performing such services everywhere.
- Sales from intangibles and all other services are assigned to California if the income producing activity that gave rise to the receipts is performed wholly within California. If the income producing activity is performed within and outside the state, then the sales from intangibles and all other services are assigned to California if the greater cost of performance of the income producing activity is performed in this state.
- Sales from the sale, rental, lease, or licensing of real property and the receipts derived from the rental, lease, or licensing of tangible personal property are assigned to California if the property is located in California.

Post 2010 Rules For Assigning Sales

Sales of Tangible Personal Property – No Change

The following are the rules for assigning sales from tangible personal property to the sales factor:

- Sales of tangible personal property are assigned to California if the product is delivered or shipped to a purchaser in this state, and the taxpayer (seller) or any member of the combined reporting group is taxable in this state.
- Sales of tangible personal property are assigned to California if the product is delivered or shipped to a purchaser out of state, and the taxpayer (seller) or any member of the combined reporting group is not taxable in the state of destination.
- Sales of tangible personal property to the U.S. Government are assigned to California if the goods are shipped from California.

Sales of Other Than Tangible Personal Property

The following are the rules for assigning sales of other than tangible personal property:

- Sales from services are in this state to the extent the purchaser of the service receives the benefit of the service in this state.
- Sales from intangible property are in this state to the extent the property is used in this state. In the case of marketable securities, sales are in this state if the customer is in this state.
- Sales from the sale, lease, rental, or licensing of real property are in this state if the real property is located in this state.
- Sales from the rental, lease, or licensing of tangible personal property are in this state if the property is located in this state.

Apportionment Formula

State law uses an apportionment formula to determine the amount of "business" income attributable to California.[9] The apportionment formula consists of property, payroll, and sales factors. Each of these factors is a fraction, the numerator is the value of the item in California and the denominator is the value of the item everywhere. The property factor includes tangible property owned or rented during the taxable year; the payroll factor includes all forms of compensation paid to employees; and the sales factor generally includes all gross receipts from the sale of tangible and intangible property.

For taxable years beginning on or after January 1, 1993, the apportionment formula for most taxpayers has been a three-factor apportionment formula consisting of property, payroll, and double-weighted sales (three-factor, double-weighted sales). An exception to this rule exists for taxpayers of an apportioning trade or business that derive more than 50 percent of its gross business receipts from conducting a "qualified business activity."[10] These taxpayers are required to use a three-factor, single-weighted sales, apportionment formula.

For taxable years beginning on or after January 1, 2011, an apportioning trade or business (other than an apportioning trade of business that derives more than 50 percent of its gross business receipts from conducting a qualified business activity), is allowed to make an annual, irrevocable election to utilize a single factor, 100 percent sales (single sales factor), apportionment formula instead of the three-factor, double-weighted sales apportionment formula.

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[9] "Business income attributable to California" is a taxpayer's "business income" multiplied by its California apportionment formula. Revenue and Taxation Code (R&TC) section 25120(a) defines "business income" as income arising from transactions and activities in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.
[10] Extractive, agriculture, savings and loan, and banks and financials.

The election must be on a timely filed original return in the manner and form prescribed by the FTB.

THIS PROVISION

This provision would make the following changes:

- Require an apportioning trade or business that has made an election to utilize the single sales factor apportionment formula to use the post-2010 rules for assigning sales of intangibles and services.

- Require an apportioning trade or business that has not made an election to utilize the single sales factor apportionment formula to use the pre-2011 rules for assigning sales of intangibles and services.

- If the single sales factor election is inoperative, require all apportioning trades or businesses to use the pre-2011 rules for assigning sales of intangibles and services.

- Provide that no inference would be drawn from the amendments made by this bill with respect to the extent to which the rules (Section 25136(a)) for the assignment of sales of intangibles and services, before and after the amendments, are intended to properly reflect the market for the activities of the taxpayer giving rise to the business income. Section 25136(a) and (b) are intended to accomplish the goal of proper market reflection in the sales assigned to California.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

	2009-10	2010-11	2011-12	2012-13
If the SSF election Is Operative, Non-electors Must Use Cost Of Performance Instead Of Market Rule		-$28	-$95	-$100

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